Economic Outlook

The nation and California recovered modestly in 2010 from the worst recession since the Great Depression. National economic output grew as did personal income in both the state and the nation, and job growth resumed. But these gains and many others like them paled in comparison to the losses incurred during the recession. The recession lasted 18 months and it officially ended in June 2009.

The principal cause of the recession was a financial crisis instigated by risky financial activity that led to the bursting of the housing bubble. Based on historical experience, economic recoveries following recessions caused by financial crises are slower and more drawn out than those stemming from other causes. This recovery follows that experience.

Although California is more than 18 months into the recovery, many Californians believe that conditions are not much improved. By many measures, the economy was on the mend in 2010; however, the slowdown wrought by the housing implosion and financial crisis was so severe that the pace of economic recovery continues to be discouraging. Unemployment remains high across the country and especially in California. Home building still lags below the pace of construction set before the housing bubble inflated. Similar trends continue in other areas such as industrial production and notably, home, and retail sales.

Both the nation and California started 2010 mired in an anemic recovery brought about by the nature of the recession that preceded it. The financial balance sheets of many households were still reeling from the financial upheaval and the decline in home values. It is estimated that the financial crisis cost households and non-profit organizations $11 trillion in assets—nearly a year's worth of national economic output.

The loss of these assets led to financial retrenchment as consumers became thriftier, and households began saving more. While this will have positive effects in the long run, it means less consumer spending now. In turn, this lower level of consumer spending makes businesses cautious. Thus, despite surging profits, corporations have refrained from hiring and have instead opted to increase their cash reserves. Unfortunately, weak employment growth restrains consumption spending. This creates a "Catch-22" —without more spending, hiring will remain weak.

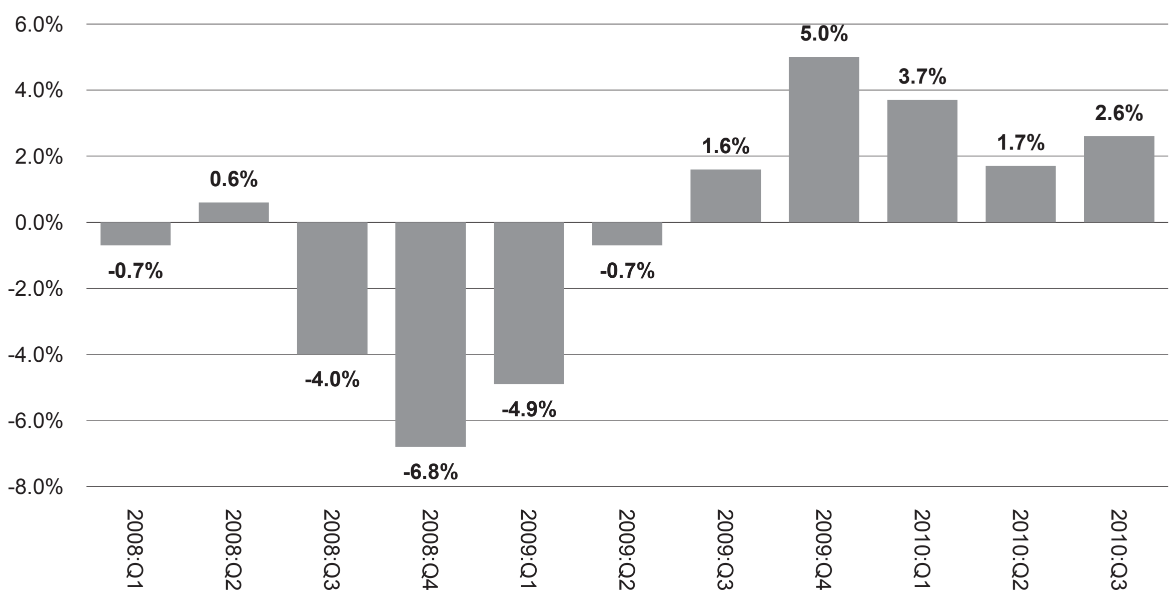
The Nation— Tentatively On The Mend

Fears of a "double dip" recession were being discussed during the early months of 2010. However, subsequent economic readings improved and this fear was replaced with an expectation that the nation is in for a long and slow recovery. As 2010 came to a close, the national economy was in the midst of a "wobbly" recovery. Federal stimulus measures stopped the economy's tailspin. By the end of 2010, the impact of these measures began to diminish and economic activity moderated. After accelerating to a 5.0-percent annualized growth rate in the fourth quarter of 2009, the pace slowed to 3.7 percent in the first quarter of 2010 and to only 1.7 and 2.6 percent in the second and third quarters, respectively. This is reflected in Figure ECO-01.

Figure ECO-01

U.S. Real Gross Domestic Product

Quarter-to-Quarter growth, annualized



Source: U.S. Commerce Department, Bureau of Economic Analysis

Throughout 2010, many economic indicators languished at disappointing levels —even though they did improve from 2009 levels. The following issues help demonstrate the mixed economic news.

Vehicle Sales—Vehicle sales stabilized and began a modest but irregular rebound. During the six months ending with November 2010, motor vehicle sales averaged nearly 12 million units—better than the 2009 average, but well below the 16-million-unit pace set during the late 1990s and early 2000s.

New Home Construction—After falling precipitously from 2006 through 2009, the national pace of housing starts during the first quarter of 2010 was up by more than 16 percent from the same time in 2009. However, this pace—about 600,000 units on an annualized basis—was still 60 percent behind the pace set before the housing bubble.

Home Prices—Home prices began to stabilize in 2010 and improved in many regions. According to the Case-Shiller Home Price Index, home prices in September 2010 were 0.6 percent above their year-ago level—the eighth straight month of year-over-year increases following 37 straight months of year-over-year declines. However, home prices were still 30 percent below their April 2006 peak—similar to what they were in November 2003. While the turnaround in 2010 was very welcome news, home prices are far from resembling pre-recession conditions.

Manufacturing—Manufacturing activity expanded for the 16th consecutive month in November 2010 following 18 months of declines. However, because of the deep declines that occurred during 2008 and 2009, the level of factory activity was still subdued, with ample unused capacity.

Consumer Sentiment—At the end of 2010, consumer sentiment was stuck at recessionary levels. Households were still worried about the economy, as their assessments of both current conditions and the future were subdued.

Unemployment—Even though 2010 began with a return to sustained job growth, it will take a long time to regain the eight million jobs lost during the recession. Job losses averaged 395,000 per month during 2009. The nation added about 86,000 jobs per month during the first eleven months of 2010. However, the unemployment rate is still high — 9.8 percent in November. At the end of November 2010, there were 7 million more unemployed Americans than there were at the beginning of the recession. More robust job growth will be needed to keep the recovery moving ahead.

Of the issues listed above, employment remains the biggest source of concern. The level of employment is still very low, and it could take a long time to recover all of the lost jobs. One reason for this is that the unemployment rate often remains high after employment begins to recover, because workers who had given up looking for work during the recession re-enter the labor force, driving up the unemployment rate.

Additionally, hiring usually lags behind output during the early stages of a recovery. This lag exists because firms tend to increase output first by boosting productivity and by raising the number of hours worked by existing employees. Hiring new employees tends to occur later. Thus, even though corporate profits have recovered from the depths of the recession, businesses have not expanded their payrolls — at mid-2010, non-financial corporations' cash balances were up 26 percent from a year earlier. However, one hopeful sign is that equipment spending increased in 2010 as firms focused on increasing productivity. It is forecasted that businesses will begin spending again and expanding payrolls. Given the uncertainty surrounding the timing of this expansion in hiring, most forecasts have been cautious. According to the current outlook, the unemployment rate will improve gradually and may not reach "full employment" for several years.

As discussed earlier, a full-bodied economic recovery appears to be waiting for the return of sustained job growth. As long as labor markets are soft, consumers will be wary and thrifty, but employers are reluctant to hire and invest in the face of restrained consumer spending.

California — Reflecting The Nation

The state roughly paralleled the nation through the recession and into the recovery. However, in addition to being one of the states hardest hit by the collapse of the housing market, California's state and local budget problems turned public sector employment into a source of weakness. Some of the California specific economic factors are detailed below.

Vehicle Sales — Vehicle sales declined severely in 2008 as the housing crisis unfolded. New automobile registrations at the end of 2008 were down over 40 percent from a year earlier. A tentative recovery began in the middle of 2009, spurred initially by the federal "Cash for Clunkers" incentive program. Registrations in the first nine months of 2010 were up 11 percent from a year earlier. However, the level of registrations during these months was still off 40 percent from the same months of 2006.

New Home Construction—The worst of the housing slump may be over. Home building permitting, which suffered a long steady three-year decline starting in 2006, stabilized at a very low level in 2009. Spurred by the on-again/off-again federal home buyers tax credit and, to a lesser extent, by California's first-time buyer tax credit, permitting improved fitfully throughout most of 2010. The issuance of housing permits rose nearly 18 percent during the first ten months of the year from the same months of 2009. However, the number of permits issued was still down 80 percent from the peak reached in mid-2005.

Home Prices—Residential real estate markets also stabilized in 2009 as home prices appreciated, inventories shrank, and the pace of sales stabilized at a sustainable rate. This, however, yielded to mixed results in 2010, leaving the resiliency of the housing recovery in question.

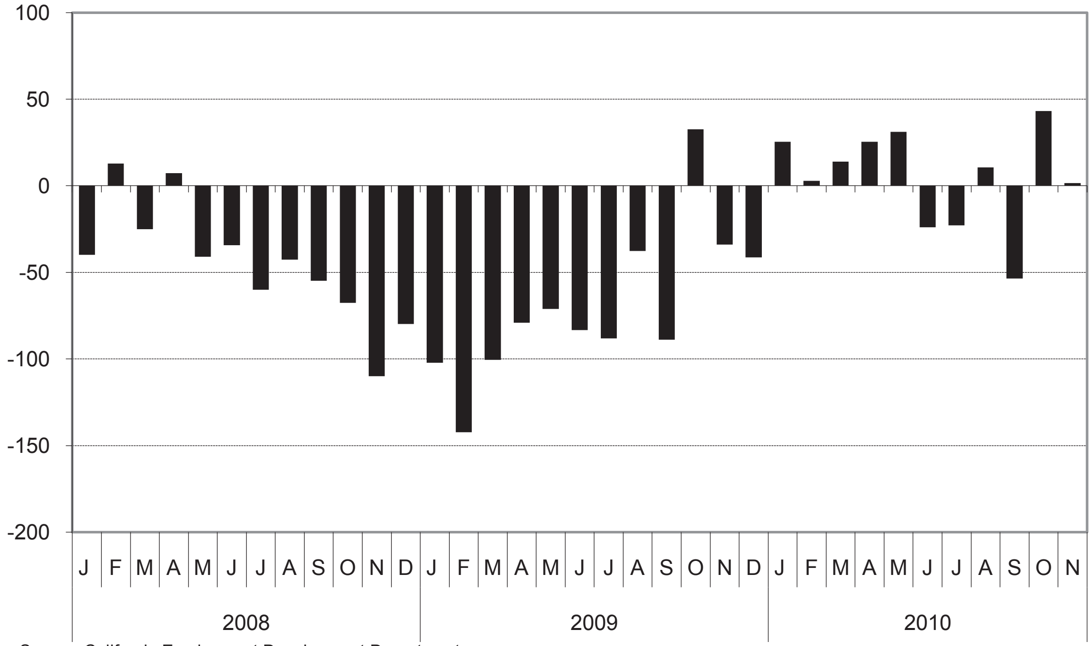
Made-in-California Exports—California exports plummeted during the final quarter of 2008 and the first quarter of 2009. California exports fell 17 percent in 2009 from 2008 levels. High-tech exports fell by nearly 16 percent. With global economic conditions easing up, California exports began recovering in the fourth quarter of 2009. Exports during the first half of 2010 were up by more than 21 percent compared to the first half of 2009.

Taxable Sales—Taxable sales deteriorated dramatically in 2008, bottomed out early in 2009, and recovered modestly during the rest of the year and into 2010. Sales during the first half of 2010 were up 4 percent from the first half of 2009, but were still down 17 percent from the peak reached in the first half of 2007.

Employment—California suffered its worst job losses on record during the latter half of 2008 and the first six months of 2009—losing nearly a million nonfarm jobs. These losses moderated during the second half of 2009 and switched to very modest gains in 2010. As with the nation, it will likely take a long time for employment to reach pre-recession levels. The national unemployment rate peaked at 10 percent in the last quarter of 2009 and declined sporadically through July 2010. The state's rate, in contrast, continued to trend up to 12.6 percent in March 2010, and then improved slightly thereafter (Figure ECO-02).

Personal Income—The huge toll of lost jobs depressed California personal income, which declined in 2009 on a year-over-year basis for the first time since 1938. Personal income fell in the first three quarters of 2009 before increasing moderately in the fourth quarter. For 2009 as a whole, personal income fell over $38 billion, or 2.4 percent,

Figure ECO-02
Month-to-Month Change in California Payroll Employment
1,000s of Nonfarm Jobs, Seasonally Adjusted



Source: California Employment Development Department

from 2008. Personal income during the first two quarters of 2010 was up 1 percent from the same period in 2009.

The Forecast

The California and national economies entered 2011 in the midst of a weak recovery from the worst recession of the post-World War II era. A sharp rebound does not appear likely. Rebuilding household balance sheets requires restrained consumer spending; and that restraint in turn will provide for only modest job growth for some time.

This forecast assumed that the Federal Reserve would apply quantitative easing through the purchase of $600 billion in long-term Treasury bonds and that Congress would extend both the existing federal income tax cuts and long-term unemployment benefits. This forecast did not, however, envision the addition of new payroll tax relief. While all of these measures should have positive economic impacts, their ultimate effect is uncertain.

On the other hand, European financial troubles present a potential major threat on the road to recovery. The specter of national defaults still haunts the European economies.

The loss of confidence in Greece, and most recently Ireland, presents the possibility of a spreading debt crisis whose fallout, although nearly impossible to anticipate at this point, could potentially rival the financial meltdown that struck the United States at the end of 2008. At the very least, the austerity measures proposed to deal with these crises will place a significant drag on European economic growth and put downward pressure on demand for U.S. exports.

The outlook for the national economy is for tepid growth in 2011, followed by moderate growth in 2012 and 2013. Real Gross Domestic Product is projected to grow by 2.2 percent in 2011, 2.9 percent in 2012, and 2.7 percent in 2013. After falling 0.5 percent in 2010, nonfarm payroll employment is forecast to grow 1.0 percent in 2011, 1.8 percent in 2012, and 1.9 percent in 2013.

For California, income and job growth will likely be modest for the foreseeable future. There will be moderate growth in 2011 followed by better—but sub-par—growth in 2012 and another step toward normal growth rates in 2013. Personal income is projected to grow 3.8 percent in 2011, 4.0 percent in 2012, and 5.1 percent in 2013. This is a definite improvement from the 2.4-percent decline suffered in 2009, but weak compared to the 5.1-percent average annual growth rate achieved from 1989 to 2009. After falling by 1.2 percent in 2010, nonfarm payroll employment is forecast to grow by a slim 1.2 percent in 2011—a rate that fails to keep pace with the growth of the working-age population. The job market fares better in 2012 with 1.8-percent growth that accelerates to 2.2 percent in 2013.

The state is forecast to recover the nonfarm jobs lost during the recession in the third quarter of 2016, or approximately 87 months after the end of the recession. During the previous six recessions, full job recovery was achieved between 4 and 56 months.

In California, weak real estate markets and constrained home building are significant impediments to a strong recovery. There is some uncertainty about the resilience of the stability achieved during 2010. It is still unclear how much of the improvement seen in 2010 was the result of the temporary boost provided by tax credits. Fears persist of a "shadow supply" of existing homes, including bank-owned properties being held out of the market by lenders and investors. A "shadow supply" could prevent further home price recovery. This, in turn, could lead to depressed home building into the future (Figure ECO-03).

Figure ECO-03

Selected Economic Data for 2010, 2011, and 2012

United States	2010 (Est.)	2011 (Projected)	2012 (Projected)
Real gross domestic product (2005 CW* $, percent change)	2.7	2.2	2.9
Personal consumption expenditures	1.6	2.3	2.1
Gross private domestic investment	17.4	2.9	12.6
Government purchases of goods and services	1.0	0.1	(1.4)
GDP deflator (2005=100, percent change)	1.0	1.3	1.4
GDP (current dollar, percent change)	3.7	3.5	4.4
Federal funds rate (percent)	0.2	0.1	1.2
Personal income (percent change)	2.7	3.1	3.9
Corporate profits before taxes (percent change)	28.5	3.7	5.3
Nonfarm wage and salary employment (millions)	130.2	131.5	133.9
(percent change)	(0.5)	1.0	1.8
Unemployment rate (percent)	9.7	9.6	9.1
Housing starts (millions)	0.60	0.77	1.21
(percent change)	9.0	27.1	57.8
New car sales (millions)	5.6	6.6	7.9
(percent change)	3.4	16.3	20.1
Consumer price index (1982-84=100)	218.0	221.0	224.8
(percent change)	1.6	1.4	1.7
California			
Civilian labor force (thousands)	18,247.0	18,456.3	18,756.0
(percent change)	(0.0)	1.1	1.6
Civilian employment (thousands)	15,976.6	16,222.9	16,634.2
(percent change)	(1.2)	1.5	2.5
Unemployment (thousands)	2,270.4	2,233.4	2,121.8
(percent change)	9.0	(1.6)	(5.0)
Unemployment rate (percent)	12.4	12.1	11.3
Nonfarm wage and salary employment (thousands)	13,942.1	14,106.7	14,365.9
(percent change)	(1.2)	1.2	1.8
Personal income (billions)	1,614.4	1,675.4	1,742.4
(percent change)	2.7	3.8	4.0
Housing units authorized (thousands)	42.6	73.6	122.0
(percent change)	16.6	72.7	65.9
Corporate profits before taxes (billions)	154.8	163.1	175.3
(percent change)	19.1	5.4	7.5
New auto registrations (thousands)	1,096.3	1,285.0	1,349.3
(percent change)	1.4	17.2	5.0
Total taxable sales (billions)	474.0	507.6	551.2
(percent change)	4.2	7.1	8.6
Consumer price index (1982-84=100)	227.0	230.4	234.2
(percent change)	1.3	1.5	1.7

* CW: Chain Weighted

Note: Percentage changes calculated from unrounded data.